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SUBJECT: URUGUAY CONTINUES TO EXPERIENCE STRONG ECONOMIC GROW AND REDUCES EXTERNAL VULNERABILITIES

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Summary

¶1. SUMMARY: Uruguay continued to experience exceptional economic growth in the first quarter of 2008, fostered by robust consumer spending, high commodity prices and the start-up of operations by Botnia's giant paper pulp mill. Over the past couple of months, Economy Minister Danilo Astori and Central Bank officials have repeatedly stressed that Uruguay is in a much better position to face external shocks than it was prior to the 2002 crisis. While Uruguay is undoubtedly less dependent on regional developments, several structural weaknesses remain that make it vulnerable to a global downturn. END SUMMARY.

Continued exceptional growth

¶2. Uruguay's economy continued to grow at an exceptional rate in the first quarter of 2008, with 10.9% GDP real growth vis-a-vis the first quarter of 2007. Transportation and communications was the most vibrant sector, up 27%, while industry followed with a 13% hike, fostered by the start-up of operations by Finnish Botnia's paper pulp mill. Private consumption increased 8% in real terms, fueled by higher employment and rising wages, and investment rose by 17%. Exports rose 12% in real terms (over 34% in dollar terms), thanks to increasing sales of paper pulp and the high prices of agricultural commodities. In turn, imports stepped up 11%, due to higher purchases of capital goods and raw materials (a reflection of strong growth) and of consumer goods (a result of higher employment, rising wages and a cheap dollar). Measured in dollar terms, imports rose 54%, in large part because of the surge in oil prices.

Positive developments

¶3. Over the past couple of months, Economy Minister Astori and Central Bank officials have repeatedly stressed that Uruguay is in a much better position to face external shocks than it was prior to the 2002 crisis. While some analysts highlight that rising public expenditure may pose a threat to fiscal accounts in the near future, the GOU currently runs a moderate fiscal deficit of under 0.5% of GDP. The GOU has also implemented a successful debt management program that has lowered the debt/GDP ratio (down to 69% from a 2003 high of 110%), extended the debt's maturity (the share of total debt maturing in under five years dropped from 47% in 2002 to 23% in 2007) and reduced risk by increasing the share of peso-denominated debt (from 4% in 2002 to 31% in 2007).

¶4. Central Bank reserves are at a historically high level of $5.3 billion, almost ten times higher than in the midst of the 2002 banking crisis. Moreover, following the crisis, the Central Bank greatly improved its supervision policies and instated an explicit bank deposit insurance. Local banks are in good shape with high liquidity, growing deposits and low exposure to neighboring Argentina. Uruguay has also

significantly reduced its trade dependency on the region, with its Mercosur partners now purchasing about 28% of Uruguay's exports, down from 55% in 1998.

Inflation is rising but still under control

¶5. Inflation accelerated in 2007 but still remains under control at an annual rate of 7%-8%. The GOU is trying to persuade basic foodstuff producers to supply some products at low prices, but has so far refrained from imposing mandatory price controls or restrictions on exports to control inflation. Instead, it recently passed a comprehensive anti-inflation package that, among other measures, raised the mandatory reserves for banks, in order to cool the economy. This is meant to prevent further depreciation of the dollar, which would have resulted from an increase in peso-denominated interest rates.

However, several weaknesses remain

¶6. Some structural weaknesses remain, however, that make Uruguay vulnerable to a deceleration in global growth. Indebtedness remains high at 69% of GDP, and a major part of the decline in the debt/GDP ratio is due to the strong rise in GDP measured in dollar terms caused by the drop in the value of the dollar (the GDP rose 40% in constant terms in the 2002-2007 period, and 88% in dollar terms). Public expenditures are rigid, as pensions, wages and interest payments account for 70% of total spending. A low investment ratio at only 15% of GDP, a high concentration of exports in agro-industry (over two-thirds of total exports of goods), and a high dependency on oil imports (jumping from under $1 billion in 2006 to an expected $1.5 billion in 2008) are

other vulnerabilities.

Comment: In a strong situation, but still vulnerable

¶7. COMMENT: Uruguay is certainly in a much better position to face external shocks than it was prior to its financial crisis of 2002. It has also diversified its trade and become less dependent on its Mercosur neighbors than it once was. Still, the country's high debt level and high dependency on agricultural commodities exports and oil imports make it vulnerable to a global downturn.

Baxter